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Corporate income taxation in Vukovar: can we trace the effects of tax exemption?

Since the beginning 2007, corporate income has no longer been a joint tax the revenue from which is shared between different levels of government. Despite that, it is interesting to view the City of Vukovar budget, which has had a special status in the corporate income tax system since the peaceful reintegration. The Vukovar budget would, in fact, have collected 7.5 times greater corporate income tax revenue in 2006 if its taxpayers had not been exempted from the payment of the tax.

The Croatian taxation system is characterized not only by numerous and frequent legislative changes but also by numerous tax reliefs, exemptions, incentives and other preferences. Their most frequent domains are personal and corporate income tax. They are used to help, for example, areas devastated by war by stimulating investments and economic growth. In a much wider sense all of these preferences are called tax expenditures. No matter which form of taxation is considered, introducing such tax preferences also has a series of negative consequences. Their range includes a more complicated and more expensive tax system, violations of its consistency and transparency, all the way to a decline in the tax base and loss of tax revenue. An example of such tax expenditure is the corporate income tax exemption in the City

of Vukovar used by the Government to stimulate faster economic growth and employment increase.

From the year 2000 to 2005, according to the Corporate Income Tax Law and a bylaw (NN 127/00 and 132/00) taxpayers who carried out an activity in the area of the city of Vukovar and permanently employed more than 5 employees, with more than 50% of the employees having their domicile and habitual residence in the city of Vukovar area), were completely exempt from paying corporate income. From 1 January 2005 with the Amendments on the Law (NN 177/04, 90/05 i 57/06) taxpayers in Vukovar were, if they met the above mentioned criteria, exempt from the payment of the tax for the following 10 years. With the newest Amendments on the Law on Financing of Units of Local and Regional Self-Government (NN 132/06) dating from the year 2007 the corporate income tax revenue is no longer shared among different levels of government, but is an exclusive central government budget revenue. The exemptions, however, remain the same until the year 2015.

The Institute of Public Finance deals with economic research and analysis related to various forms of public finances such as the budget, taxation and customs duties. Its orientation is thus to the various economic, legal and institutional topics that are important for the sound long-term economic development of the Republic of Croatia. So that the public should be able to have a better insight into certain issues, the Institute of Public Finance is launching its Newsletter, in which it will from time to time publish informed and independent analysis of economic questions. The views expressed in the articles published in the Newsletter will reflect the opinions of the authors, which do not necessarily coincide with those of the Institute as institution. Full text of Newsletter is also available on Institute's Web site: <http://www.ijf.hr/newsletter>.

The aim of this article is to analyze the total revenue and total profit tax exemption for Vukovar in the period of 2001 to 2006, and to determine the effects of deductions on the tax revenue.

In table 1 total tax revenue, corporate income tax revenue and corporate income tax exemption for Vukovar are shown:

Total Vukovar tax revenue has doubled in the analyzed period (from 22 million kuna in the year 2001 to 44 million kuna in 2006). Corporate income tax revenue has also grown, but not so significantly; from 3.6 million kuna in 2001 to 5.2 million kuna in the year 2006. However, corporate income tax exemptions have increased on a much larger scale (from 5.5 to more than 37 million kuna). As a result the city treasury was "impoverished" by 5 million kuna in 2001, as compared to the 34 million kuna in 2006. In other words, these figures represented potential revenue up to the year 2007 (90% of the total collected corporate income tax revenues) which the city treasury was not able to collect. In that way, for example, only in the year 2006 lost city treasury revenue was smaller than the total Vukovar tax revenue by just 10 million kuna because of this tax exemption.

It is also visible from table 1 that, due to this exemption, for all observed years city treasury losses are significantly larger than total corporate income tax revenues of

the city. Accordingly, Vukovar "total potential corporate income tax revenue" (sum of the collected corporate income tax and the given tax exemptions) grew from 9 million kuna in 2001 to 39 million kuna in 2006.

Analysis of the total collected and lost corporate income tax revenue provided some interesting information. From 2001 to 2006, on average, for 1 kuna which the City treasury collected on the basis of its share in corporate income tax, as many as 4 kuna were allowed to get away. For instance, only in 2006 the Vukovar treasury would have collected as much as 7.5 times more corporate income tax revenue if it had not been for this exemption. Table 2 shows the total number of users of this exemption and the average number of unemployed in Vukovar.

According to the data in table 2, the average number of unemployed people in Vukovar decreased slightly in the period from 2003 to 2006, while the number of tax exemption users more than doubled, although the number is still not significant. These figures do not reveal much by themselves, but due to the fact that this tax exemption will exist by the current regulations until the year 2015, it is crucial to determine whether it has accomplished its main objectives or not. The mentioned goals were employment growth, a more propulsive economic activity and higher tax revenue. The questions of the exemption's justifiability are currently almost im-

Table 1: Vukovar financial indicators analysis

mil. kuna	2001	2002	2003	2004	2005	2006	2001 - 2006
A Total Vukovar tax revenue	22.4	22.3	26.6	36.8	43.2	44.0	162.3
B City of Vukovar and Vukovar-Srijem county total corporate income tax revenue collected at the city level *	4.1	1.6	1.9	2.4	6.4	5.8	22.2
C City of Vukovar corporate income tax revenue (90% of B)*	3.6	1.4	1.7	2.2	5.7	5.2	19.8
D Total profit tax exemption for Vukovar tax payers*	5.5	6.5	10.0	13.0	19.6	37.3	91.9
E City of Vukovar budget "losses" from the corporate income tax exemption (90% out of D)*	5.0	5.9	9.0	11.7	13.7	33.6	78.9
B+D Potential Vukovar and Vukovar-Srijem county corporate income tax revenue	9.6	8.1	11.9	15.4	26.0	43.1	114.8
C+E Potential Vukovar corporate income tax revenue	8.6	7.3	10.7	13.9	19.4	38.8	98.7
%							
E/A Share of lost revenue in the total Vukovar tax revenue (%)	22.3	26.5	33.8	31.8	31.7	76.4	37.1
E/C Share of lost revenue in the Vukovar corporate income tax revenue (%)	138.9	421.4	529.4	531.8	240.4	646.2	418.0

* Corporate income tax revenue collected in the City of Vukovar until the beginning of 2007 when this tax became an exclusive central government budget revenue was shared on a 90:10 basis between Vukovar and Vukovar-Srijem county.

Source: Ministry of Finance and Tax Administration reports

Table 2: Number of users of tax exemption and the average number of unemployed in Vukovar

	2001	2002	2003	2004	2005	2006
Number of users of tax exemptions	25	27	37	34	35	60
Average number of unemployed residing in Vukovar	-	-	3,471	3,433	3,336	3,156

- 2001 and 2002 data are not available because unemployment records were not kept according to the place of residence.

Source: Tax Administration, Croatian Employment Service, District Service of the City of Vukovar

ssible to answer. Statistical records of the total amounts involved and the number of users of this tax exemption (thus also the number of people employed on the basis of this regulation) allegedly exist, but its direct effects on the city development per se and on employment growth have not been explored nor have they been made publicly available. However, these questions could and must be relatively easily responded to. The precondition for that is a quality, up to date and publicly available statistical database to incorporate all essential indicators related to this tax exemption. The latter would include data on total corporate income tax revenue, total tax expenditure, i.e. the lost budgetary revenue and additional administrative costs. Such a database should be managed by the Regional Office of the Croatian Employment Service in cooperation with the Tax Administration Regional Office in the City of Vukovar.

Considering that from the beginning of the year 2007 corporate income tax has no longer been shared among different levels of government, rather is an exclusive national government budget revenue, it is firstly in the best interests of the Government to know if this kind of tax preference is justifiable. This is just one of a few Vukovar tax preferences, so we can imagine the situation of employees of the Vukovar Tax Administration branch

office who are, instead of collecting tax, doing exactly the opposite. For the Vukovar tax branch office acts like a social service by exempting physical and legal persons from tax payment after processing the tax reports. At the same time we do not know the size of the administrative costs of Vukovar tax payers' preferences.

Adaptation to the EU taxation system will require additional modifications of the corporate income tax law, so a high-quality and detailed analysis would help Government authorities to choose the direction of further taxation policy movements. In conjunction with this there is the need and the possibility to help certain specific groups of tax payers in favorably tax treated districts. It will be essential to choose a transition to direct transfers from the state budget as a much more cost effective and easier way of providing aid. This analysis has shown how much revenue the city of Vukovar budget has lost because of given corporate income tax exemptions until year 2006. Nevertheless, it would be even more interesting to explore if the increased share in personal income tax has resulted in an increase of city budget revenue, and how large this was. Such an analysis might possibly justify the latest taxation policy changes. Until then all questions remain unresolved.

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